AUDIT COMMITTEE - 25 OCTOBER 2019

TREASURY MANAGEMENT MID-YEAR MONITORING REPORT 2019/20

1. PURPOSE

1.1. New Forest District Council adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, last updated in 2017. The CIPFA code requires the Council to approve a treasury management strategy before the start of the year and semi-annual and annual treasury management reports.

2. SUMMARY

2.1. The Council's Treasury Management Strategy (TMS) for 2019/20 was approved at a meeting of the Council in February 2019. The Council has borrowed and invested sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

2.2. Treasury management in the context of this report is defined as:

"The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2.3. Hampshire County Council's Investments & Borrowing Team has been contracted to manage the Council's treasury management balances since March 2014 but overall responsibility for treasury management remains with the Council. No treasury management activity is without risk and the effective identification and management of risk are integral to the Council's treasury management objectives.

2.4. All treasury activity has complied with the Council's revised Treasury Management Strategy and Investment Strategy for 2018/19, and all relevant statute, guidance and accounting standards. In addition, support in undertaking treasury management activities has been provided by the Council's treasury advisers, Arlingclose.

3. EXTERNAL CONTEXT

3.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions have been made to date in 2019/20.

Economic commentary

3.2. UK Consumer Price Inflation (CPIH) fell to 1.7% year on year in August 2019 from 2.0% in July, weaker than the consensus forecast of 1.9% and below the Bank of England's target.

3.3. Labour market data for the three months to July 2019 showed the unemployment rate edged back down to 3.8% while the employment rate remained at 76.1%, the joint highest since records began in 1971. Once adjusted for inflation, real wages were up 1.9% on an annual basis as wages continue to rise steadily and provide some upward pressure on general inflation.

3.4. There was a contraction of 0.2% in quarterly GDP growth in the second calendar quarter of 2019 following the 0.5% gain in Q1, which was distorted by stockpiling ahead of Brexit. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012. Business investment fell by 0.4% (revised from -0.5% in the first estimate) as Brexit uncertainties impacted on business planning and decision-making.

3.5. The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction depending on whether or not a deal is ultimately reached by 31st October.

3.6. Globally, the European Central Bank cut its deposit rate by 10 basis points in September 2019 alongside announcing another round of stimulus, which was closely followed by a 25 basis points cut by the US Federal Reserve.

Financial Markets

3.7. After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks.

3.8. Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June, the 5-year benchmark gilt yield fell to 0.32% by the end of September. There were falls in the 10-year and 20-year gilts over the same period, with the former dropping from 0.83% to 0.55% and the latter falling from 1.35% to 0.88%. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

3.9. Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

Credit background

3.10. Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 80bps by the end of September, while for the ringfenced entity, National Westminster Bank plc, the spread remained around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 76bps at the end of the period.

3.11. There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.

4. LOCAL CONTEXT

4.1. On 31 March 2019, the Council had net borrowing of £77.0m. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below:

Table 1: Balance Sheet Summary

	31/03/2019 Balance £m
General Fund CFR	(4.9)
Housing Revenue Account CFR	(1.9)
HRA Settlement	(134.5)
Total CFR	(141.3)
Less: Resources for investment	64.3
Net borrowing	(77.0)

4.2. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31 August 2019 and the year-on-year change is shown in Table 2 below:

Table 2: Treasury Management Summary

	31/03/2019 Balance £m	Movement £m	31/08/2019 Balance £m	31/08/2019 Rate %
Long-term borrowing	(131.2)	-	(131.2)	(3.25)
Short-term borrowing	(4.3)	-	(4.3)	(1.99)
Total borrowing	(135.5)	-	(135.5)	(3.21)
Long-term investments	28.6	(4.0)	24.6	3.16
Short-term investments	28.7	11.3	40.0	1.04
Cash and cash equivalents	6.8	2.9	9.7	0.73
Total investments	64.1	10.2	74.3	1.70
Net borrowing	(71.4)	10.0	(61.2)	

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

4.3. The reduction in net borrowing of £10.2m shown in Table 2 above reflects an increase in investment balances of £10.2m. The increase in total investments since 31 March 2019 reflects the fluctuating cash position that is seen by the Council through the course of a financial year and the fact that the balance at 31 March is typically the lowest of the year.

5. BORROWING ACTIVITY

5.1. As shown in Table 2, at 31 August 2019 the Council held £135.5m of loans with the vast majority of loans being in relation to the resettlement of the HRA in 2012/13. The mid-year treasury management borrowing position and movement since 31 March 2019 is shown in Table 3 below.

Table 3: Borrowing Position

	31/03/2019 Balance £m	Movement £m	31/08/2019 Balance £m	31/08/2019 Rate %	31/08/2019 WAM* years
Public Works Loan Board	135.5	-	135.5	3.21	16.40
Total borrowing	135.5	-	135.5	3.21	16.40

* Weighted average maturity

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts but adjusted to exclude accrued interest.

5.2. The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

5.3. In keeping with these objectives, no new borrowing was undertaken in the period to 31/08/2019. This strategy enables the Council to minimise net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

5.4. The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with the monitoring of internal and external borrowing.

6. INVESTMENT ACTIVITY

6.1. The Council holds invested funds representing income received in advance of expenditure plus balances and reserves. The Council's investment holding was £74.3m principal at 31 August 2019, which was £0.37m (0.5%) lower than the same time last year.

6.2. During the five month period from 1 April to 31 August 2019, the Council's investment balance ranged between £64m and £89m due to timing differences between income and expenditure.

6.3. Table 4 below shows investment activity for the Council as at 31 August 2019 in comparison to the reported activity as at 31 March 2019. The increase in total investments since 31 March 2019 reflects the fact that the balance at 31 March is typically the lowest of the year.

Table 4: Investment Position (Treasury Investments)

Investments	31/03/2019 Balance £m	Movement £m	31/08/2019 Balance £m	31/08/2019 Rate %	31/08/2019 WAM* years
Short term Investments					
Banks and Building Societies:					
- Unsecured	8.0	5.0	13.0	0.96	0.24
- Secured	5.7	4.3	10.0	1.04	0.59
- UK Treasury Bills	0.0	2.0	2.0	0.70	0.20
Money Market Funds	6.8	1.9	8.7	0.73	0.00
Local Authorities	11.0	1.0	12.0	0.93	0.34
Registered Providers	2.0	-	2.0	1.92	0.58
Cash Plus Funds	2.0	-	2.0	1.64	n/a
	35.5	**14.2**	**49.7**	**0.99**	**0.30**
Long term investments					
Banks and Building Societies:					
- Secured	7.0	(4.0)	3.0	1.00	3.45
Local Authorities	4.0	-	4.0	1.38	1.65
Registered Providers	4.0	-	4.0	1.93	**1.58**
	15.0	**(4.0)**	**7.0**	**1.47**	**2.12**
High yield investments					
Pooled Property Funds**	7.6	-	7.6	3.96	n/a
Pooled Equity Funds**	3.0	-	3.0	6.32	n/a
Pooled Multi-Asset Funds**	3.0	-	3.0	4.18	n/a
	13.6	**-**	**13.6**	**4.53**	**n/a**
TOTAL INVESTMENTS	**64.1**	**10.2**	**74.3**	**1.70**	**0.65**

* Weighted average maturity
** The rates provided for pooled fund investments are reflective of annualised income returns over the year to 30 June 2019.

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts but adjusted to exclude operational cash and accrued interest.

6.4. The CIPFA Code and government guidance both require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the highest rate of return, or yield.

6.5. The Council's objective when investing is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

6.6. Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2019/20.

6.7. Counterparty credit quality has been assessed and monitored with reference to credit ratings, analysis of funding structure and susceptibility to bail-in of financial institutions, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

6.8. The Council also makes use of secured investment products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

6.9. To ensure sufficient liquidity, the Council makes use of call accounts and money market funds. With the uncertainty around Brexit, the Council will ensure there are enough accounts open at UK domiciled banks and Money Market Funds to hold sufficient liquidity and that its account with the Debt Management Account Deposit Facility (DMADF) remains available for use in an emergency.

6.10. The progression of credit risk and return metrics for the Council's investments managed in-house (excluding external pooled funds) are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below. The comparisons with other authorities are as at 30 June 2019.

Table 5: Investment Benchmarking (investments managed in-house)

	Credit Rating	Bail-In Exposure	WAM* (days)	Rate of Return
31/03/2019	AA-	31%	325	1.11%
30/06/2019	AA-	39%	272	1.09%
Similar LAs	AA-	63%	81	0.88%
All LAs	AA-	62%	28	0.85%

* Weighted average maturity

6.11. During the first five months of 2019/20, total investment balances increased by £10.2m as a result of the timing of front-loaded government grants and council tax receipts.

6.12. As the majority of this increase in the balance will be required over the course of the rest of the financial year, it has largely been invested in short term options, reducing the weighted average maturity of investments and increasing bail-in exposure when compared with the 31 March 2019 position.

6.13. The Council does, however, compare favourably with other similar local authorities as well as all local authority clients of Arlingclose on both measures. Approximately 61% of the Council's surplus cash is invested so that it is not subject to bail-in risk, with the remaining balance largely held in overnight money market funds, which are subject to reduced bail in risk. By comparison, only 37% of the cash held by other similar Local Authorities is not subject to bail-in risk.

6.14. The Council has targeted a proportion of funds towards high yielding investments as shown in Table 4. Investments yielding higher returns will contribute additional income to the Council, although some come with the risk that they may suffer falls in the value of the principal invested.

6.15. The £13.55m portfolio of externally managed pooled multi-asset, equity and property funds generated an annualised total return of 3.52% between the start of the financial year and the end of August 2019. This total return comprised an annualised income return of 4.83% to contribute towards the revenue budget, offset by a 1.31% fall in capital values.

6.16. It is the Council's intention to hold these investments in pooled funds for at least the medium term and they are made in the knowledge that capital values will move both up and down in the short term, but with the confidence that over a three to five-year period total returns should exceed cash interest rates, whilst also providing regular income, diversification and the potential for capital growth.

6.17. Recent changes to accounting regulations (IFRS9) have introduced a new risk related to the Council's investments in pooled funds whereby any fall in the capital value of the funds would now have to be taken as an expenditure charge to the Council's Income and Expenditure account. This does not though present an immediate risk, as there is currently a statutory override in place that provides a 4 year grace period before this requirement is implemented.

6.18. If no further changes are made at the end of the 4 year period, the risk of a fall in value resulting in an expenditure charge for the Council will be mitigated by reserves accrued through any increases in the value of the Council's investments over the next 4 years.

6.19. The performance and ongoing suitability of these pooled funds in meeting the Council's investment objectives is monitored regularly and discussed with Arlingclose.

7. NON-TREASURY INVESTMENTS

7.1. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

7.2. This could include service investments for operational and/or regeneration reasons as well as commercial investments which are made mainly for financial reasons.

7.3. The Council's existing non-treasury investments are listed in Table 6 below.

Table 6 – Non-Treasury Investments	31/08/19 Asset value £m	Annualised Rate of Return for 2019/20
Hythe Marina	2.54	6.26%
Saxon Inn Calmore	0.18	7.10%
Meeting House Lane	0.13	-
New Milton Health Centre	2.33	5.62%
Ampress Park Car Park	2.10	4.40%
Land at Beaumont Park	2.01	0%
Total	**9.29**	**4.00%**

7.4. The Councils investment property holdings total £9.29m as at 31/08/19. Two investments have been made to date in 2019; Ampress Car Park and Land at Beaumont Park. These are included within Table 6 above. Both purchases have been made pursuant to the Council's Commercial Property Strategy. The returns as shown in table 6 are inclusive of operating costs but exclude MRP (applicable to purchases made under the 2017 strategy).

8. COMPLIANCE REPORT

8.1. The Council confirms compliance of all treasury management activities undertaken during the period with the CIPFA Code of Practice and the Council's approved revised Treasury Management Strategy. Compliance the authorised limit and operational boundary for external debt is demonstrated in Tables 6 below.

Table 6: Debt Limits

	2019/20 Maximum £m	31/08/2019 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied
Total debt	135.5	135.5	186.3	201.6	✓

9. TREASURY MANAGEMENT INDICATORS

9.1. The Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

9.2. The following indicator shows the sensitivity of the Council's current investments and borrowing to a change in interest rates:

Table 7: Investment Limits

	31/08/19	Impact of +/-1% interest rate change
Variable interest rate investment exposure	£56m	+/- £0.6m
Variable interest rate borrowing exposure	£0m	n/a

9.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

9.4. This indicator is set to control the Council's exposure to refinancing risk.

Table 9: Maturity Structure of Borrowing

	31/08/2019 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	3%	25%	0%	✓
12 months and within 24 months	3%	25%	0%	✓
24 months and within 5 years	10%	25%	0%	✓
5 years and within 10 years	15%	25%	0%	✓
10 years and above	69%	100%	0%	✓

Principal Sums Invested for Periods Longer than 365 days

9.5. The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments.

Table 10: Principal Sums Invested for Periods Longer than 365 days

	2019/20	2020/21	2021/22
Actual principal invested beyond year end	£25m	£21m	£18m
Limit on principal invested beyond year end	£40m	£40m	£40m
Complied	✓	✓	✓

9.6. The table includes investments in strategic pooled funds of £13.55m as although these can usually be redeemed at short notice, the Council intends to hold these investments for at least the medium-term.

10. OUTLOOK FOR THE REMAINDER OF 2019/20

10.1. The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US, and there appears no near-term resolution to the trade dispute between China and the US.

10.2. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity.

10.3. In response, global and UK interest rate rise expectations have eased, and central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

10.4. The Council's treasury advisor Arlingclose expects Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy.

10.5. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judge the risks to be weighted to the downside and that volatility will continue to offer longer-term borrowing opportunities.

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Cas	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

11. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

11.1. None arising directly from this report.

12. RECOMMENDATIONS

Members are recommended to:

12.1. consider the performance of the treasury function detailed in this report.

Further information	**Background papers**
Please contact Rob Sarfas (HCC), or Alan Bethune	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance
	Local Government Act 2003
email: rob.sarfas@hants.gov.uk alan.bethune@nfdc.gov.uk	SI 2003/3146 Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
	Treasury Management Strategy Report 2019/20 Audit Committee – 25 January 2019 Council – 25 February 2019 Treasury Management Mid-Year Monitoring Report 2018/19 Audit Committee – 6 October 2018 Treasury Management Annual Outturn Report 2018/19 Audit Committee – 31 May 2019 Cabinet – 3 July 2019 Council – 8 July 2019
	Published Papers